

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 **COMMISSIONERS**

3 MARC SPITZER, Chairman
JIM IRVIN
4 WILLIAM A. MUNDELL
JEFF HATCH-MILLER
5 MIKE GLEASON

6 IN THE MATTER OF QWEST
COMMUNICATIONS INTERNATIONAL, INC.'S,
7 QWEST SERVICES CORPORATION'S, AND
QWEST CORPORTAION'S NOTICE OF SALE
8 REQUEST FOR WAIVER, OR APPLICATION
FOR APPROVAL OF THE SALE OF THE
9 ARIZONA OPERATIONS OF QWEST DEX, INC.

DOCKET NO. T-01051B-02-0666

DECISION NO. _____

OPINION AND ORDER

10 DATE OF HEARING:

May 16, 27, and 28, 2003

11 PLACE OF HEARING;

Phoenix, Arizona

12 ADMINISTRATIVE LAW JUDGE:

Jane L. Rodda

13 IN ATTENDENCE:

Commissioner William Mundell
Commissioner Mike Gleason

14 APPEARANCES:
15

Mr. Timothy Berg, FENNEMORE CRAIG, PC,
for Qwest Corporation;

16 Mr. Michael Patten, ROSKA HEYMAN &
17 DEWULF, PLC for Dex Holdings, LLC;

18 Mr. Daniel Pozefsky, Attorney for the
Residential Utility Consumer Office;

19 Mr. Peter Q Nyce, Jr., General Attorney for the
20 Department of Defense and Federal Executive
Agencies;

21 Mr. Thomas F. Dixon, Attorney for Worldcom;
22 and

23 Ms. Maureen Scott, Staff Attorney on behalf of
24 the Utilities Division of the Arizona Corporation
Commission.

25 **BY THE COMMISSION:**

26 On September 3, 2002, Qwest Communications International, Inc. ("QCI"), Qwest
27 Services Corporation ("QSC") and Qwest Communications ("Qwest") (collectively "Companies")
28

1 filed with the Arizona Corporation Commission (“Commission”) a request for Waiver or Application
2 for Approval of the Sale of the Arizona Operations of Qwest Dex, Inc. (“Dex”) The Companies seek
3 approval to sell the Dex directory publishing assets to Dex Holdings LLC, (“Dex Holdings”) an
4 unrelated third party buyer. In its Notice and Application, Qwest requested that the Commission
5 declare that: (1) the transaction falls within the scope of the waiver granted in Commission Decision
6 No. 58087 or (2) the sale of Directory Assets is not subject to Commission regulation based on a
7 1988 Mountain Bell Settlement Agreement. Alternatively, Qwest requested that the Commission
8 waive compliance in part with the Affiliated Interest Rules or approve the sale of directory assets.

9 In letters dated September 16, 2002 and October 25, 2002, Qwest waived and/or extended the
10 deadlines set forth in A.A.C. R14-2-806(C) and R14-2-803(B). The Commission’s Utility Division
11 Staff (“Staff”) filed a request for a procedural order on December 4, 2002.

12 On December 24, 2002, the Commission issued a Procedural Schedule that established a
13 schedule for filing testimony and set the matter for hearing on May 6, 2003.

14 The Commission granted intervention to the Residential Utility Consumer Office (“RUCO”) on October 18, 2002; to MCI Worldcom (“WCom”) on December 4, 2002; to Dex Holdings on January 10, 2003; and to the Department of Defense and Federal Executive Agencies (“DOD”) on February 4, 2003.

18 Qwest filed the testimony of its witnesses Maureen Arnold, George Burnett, Peter Cummings
19 and Brian Johnson on January 28, 2003. Dex Holdings filed the testimony of William Kennard on
20 January 28, 2003. DOD filed the rebuttal testimony of Richard Lee on March 4, 2003. RUCO filed
21 rebuttal testimony of Dr. Ben Johnson on March 19, 2003. After being granted an extension by
22 Procedural Order dated March 23, 2003, Staff filed the rebuttal testimony of Michael Brosch on
23 March 28, 2003.

24 On March 28, 2003, Staff filed notice that it had reached a settlement in principal with Qwest.
25 On April 18, 2003, Staff and Qwest filed a Joint Notice of Filing Settlement Agreement and Motion
26 for Procedural Order. A copy of the Stipulation entered into between Qwest and Staff is attached
27 hereto as “Exhibit A.” Pursuant to the March 23, 2003 Procedural Order, Qwest filed the surrebuttal
28 testimony of Maureen Arnold, Philip Grate, Peter C. Cummings and Anne Koehler-Christensen on

1 April 18, 2003.

2 In light of the Stipulation between Staff and Qwest, the Commission issued a Procedural
3 Order on April 25, 2003 setting a new schedule. Pursuant to the new schedule, on April 28, 2003,
4 Qwest filed the testimony of Maureen Arnold and Staff filed the testimony of Michael L. Brosch in
5 support of the Settlement Agreement. On the same date, Dex Holdings filed a statement in support of
6 the Settlement Agreement. On May 9, 2003, the DOD filed rejoinder testimony of Richard Lee and
7 RUCO filed the rejoinder testimony of Dr. Ben Johnson, both opposing the Settlement.

8 A hearing convened on May 16, 27 and 28, 2003.

9 Background of the Transaction

10 QCI's sale of Dex is being accomplished in two stages. The first stage is known as the
11 "Dexter transaction" and involved the sale of all Dex operations in Colorado, Iowa, Minnesota,
12 Nebraska, New Mexico, North Dakota, South Dakota and El Paso, Texas, and closed on November 8,
13 2002. The second stage is known as the "Rodney transaction", and includes the Dex operations in
14 Arizona, Idaho, Montana, Oregon, Utah, Washington and Wyoming. Qwest has stated it wants to
15 close the second stage by the end of 2003.

16 The buyer in both transactions is Dex Holdings, a Delaware limited liability company, that
17 was formed by the Carlyle Group ("Carlyle") and Welsh, Carson, Anderson & Stowe ("WCAS") to
18 purchase the Dex assets.

19 The agreed purchase price for the entire Dex publishing business is \$7.05 billion, subject to
20 adjustment for working capital and final audited Dexter and Rodney financial statements. Of the
21 total, \$2.75 billion will be allocated to Dexter and \$4.3 billion will be allocated to Rodney. Qwest
22 Corporation ("Qwest") is not a party to the purchase agreements, but did enter into a separate
23 publishing agreement with the Buyer and joined QCI in a non-competition agreement with Buyer.

24 In addition to the Dexter and Rodney purchase agreements, the parties executed the following
25 ancillary agreements: a Separation Agreement for sharing of assets, systems and facilities between
26 Dexter and Rodney following the Dexter closing; Transition Services Agreement whereby QCI and
27 its subsidiaries will provide back-office and other support services to Dexter following the first
28 closing for a period of up to 18 months; Professional Services Agreement whereby Dexter will

1 provide necessary centralized services that Rodney will require following the first closing as a result
 2 of the transfer of certain personnel to Dexter at the first closing; Joint Management Agreement
 3 whereby Rodney and Dexter will each employ key senior management team executives during the
 4 transition period; Publishing Agreement that designates the Buyer as Qwest's exclusive official
 5 publisher in the region; Directory License Agreement that grants the Buyer a restricted license to use
 6 the directory publisher and directory delivery lists; Non-Directory License Agreement giving Buyer a
 7 restricted license to use the subscribers list information in its direct marketing activities for a term of
 8 five years; Public Pay Stations Agreement under which Buyer will place directories in Qwest's public
 9 pay stations for the term of the publishing agreement; IP Contribution Agreement which assigns the
 10 intellectual property used in the yellow pages business to the Buyer; and a Trademark License
 11 Agreement which gives the Buyer a license to use the "Qwest Dex" trademark for five years.

12 The two closings are conditioned, *inter alia*, upon (a) receipt of debt financing on the terms
 13 set forth in Buyer's commitment letters, (b) the separation of the Dexter and the Rodney businesses
 14 and (c) the termination or expiration of the applicable waiting period under the Hart-Scott-Rodino
 15 Act. In addition, the Rodney closing may not occur in the event that state commissions, individually
 16 or collectively, order gain sharing, rate reductions, additional capital investments or other forms of
 17 economic loss to QCI and/or its subsidiaries, including Qwest, in excess of a specified level.

18 Qwest testified that QCI's decision to sell Dex is an attempt to preserve and strengthen its
 19 financial integrity. According to Qwest's witness, QCI's and Qwest's steadily worsening financial
 20 situations and debt loads began to impact their ability to obtain financing at the beginning of 2002. In
 21 January 2002, QCI had declining EBITDA¹, declining revenues, and over \$25 billion in debt. QCI's
 22 stock price was in deep decline, having fallen from the mid \$40s in January 2001 to the mid-teens by
 23 January 2002, and eventually as low as \$1.07 on August 7, 2002. Both QCI and Qwest were locked
 24 out of the short-term commercial paper market and saw their bond ratings decline to junk status.
 25 Qwest states that these financial downturns left QCI in the position of not being able to service its
 26 debt obligations. QCI had fully drawn on its \$4.0 billion line of credit as result of being shut out of
 27

28 ¹ Earnings Before Income Taxes, Depreciation and Amortization

1 the commercial paper market, and faced default under that facility if it could not reduce its debt and
 2 find a cash source to meet its obligations which were scheduled to mature May, 2002, and which
 3 were subsequently extended to May, 2003.

4 Qwest states that selling Dex is a critical component in its overall debt restructuring and de-
 5 leveraging. Qwest witnesses testified that the Dex sale was essential to QCI successfully negotiating
 6 QCI's Second Amended and Restated Credit Agreement ("ARCA"). The ARCA extended maturities
 7 under QCI's prior credit agreement and relaxed the debt-to EBITDA covenant ratios under the prior
 8 Credit agreement. Qwest witnesses testified that if QCI had not been able to negotiate the ARCA it
 9 would likely have defaulted on its debt obligations. Qwest states that while the ARCA and the first
 10 phase of the Dex sale have improved its financial condition, the proceeds of the second phase of the
 11 Dex sale remain critical to further reduce debt and return the companies to financial health.

12 The Relationship between Qwest and Directory Publishing and
 13 Pre-Settlement Positions

14 Prior to 1983, Mountain States Telephone and Telegraph ("Mountain Bell") was a Bell
 15 Operating Company ("BOC") providing telecommunications service in Arizona as a subsidiary of
 16 American Telephone and Telegraph Company ("AT&T"). At the divestiture of AT&T, Mountain
 17 Bell became a wholly-owned subsidiary of US West, Inc. the regional holding company serving
 18 Arizona and other western states. The Modified Final Judgment that accomplished the divestiture of
 19 AT&T assigned the directory publishing assets to each BOC that had been publishing white and
 20 yellow page directories prior to divestiture.

21 In 1984, Mountain Bell transferred its directory publishing assets and business to its affiliate
 22 US WEST Direct ("USWD"), another subsidiary of US West, Inc. The Commission challenged the
 23 transfer by issuing an Order to Show Cause why Commission approval was not necessary in light of
 24 A.R.S. § 40-285.² In that proceeding the Commission declared the transfer of directory publishing
 25 assets to USWD void. See Decision No. 55755 (October 8, 1987). Mountain Bell appealed the

26 ² A.R.S. § 40-285 provides that "A public service corporation shall not sell, lease, assign, mortgage or otherwise dispose
 27 of or encumber the whole or any part of its railroad, line, plant, or system necessary or useful in the performance of its
 28 duties to the public, or any franchise or permit or any right thereunder, nor shall such corporation merge such system or
 any part thereof with any other public service corporation without first having secured from the commission an order
 authorizing it to do so. Every such disposition, encumbrance or merger made other than in accordance with the order of
 the commission authorizing it is void."

1 decision in Superior Court.

2 To resolve the challenge to Decision No. 55755, Staff and Qwest entered into a Settlement
3 Agreement which the Commission approved in Decision No. 56020 (June 13, 1988) ("1988
4 Settlement Agreement"). The 1988 Settlement Agreement provided that (1) the transfer of directory
5 publishing assets from Mountain Bell to USWD was valid; and 2) the Commission would "take no
6 further action to challenge that transfer." Further, in Section 3(c) the 1988 Settlement Agreement
7 provides:

8 in future rate cases filed by Mountain Bell, the Commission, in arriving at
9 the test year operating income of Mountain Bell, will consider the fees and
10 the value of services received by Mountain Bell from USWD under
11 publishing agreements with USWD; that Mountain Bell and the
12 Commission Staff may present evidence in support of or in contradiction
13 to those fees and the value of those services. Mountain Bell and the
Commission agree that in subsequent rate cases downward adjustments
from the \$43 million in fees received by Mountain Bell from USWD and
included in Mountain Bell's 1984 rate case will require more than a
showing by Mountain Bell that it negotiated a lesser amount with
USWD."

14 In July of 1993, Mountain Bell's successor, US WEST Communications, Inc. ("USWC")
15 filed an application for a rate increase. USWC did not seek to change the \$43 million annual
16 imputation or the value of fees and services from USWD. In that case, Staff recommended that the
17 imputation be increased to \$60 million based on the profitability of USWD's Yellow Pages. The
18 Commission adopted Staff's recommendations in Decision No. 58927 (January 3, 1995). USWC
19 appealed Decision No. 58927 directly to the Arizona Court of Appeals.

20 In US WEST Communications Inc. v. Arizona Corp. Com'n, 185 Ariz. 277, 915 P.2d 1232
21 (App. 1996), the Court of Appeals held that the Commission's \$60 million directory imputation
22 violated the 1988 Settlement Agreement. The Court found:

23 It is wholly inconsistent with this agreement to impute to US West all of
24 USWD's profits in exceeding the rate of return USWD would have been
25 permitted to receive had it remained regulated and to seek thereby for
26 'ratepayers the same benefit from the directory publishing business as they
27 had before the assets were transferred.' By such a methodology the
28 Commission in effect pretends that the transfer it previously accepted did
not occur. The imputation method approved in the agreement was not the
excess-profit imputation adopted by the Commission but rather a method
dependent upon proof of the 'fees and the value of service received by
Mountain Bell from USWD under publishing agreements with USWD.'

1 Id. at 281, 915 P.2d at 1236.

2 In Qwest's 1999 rate case, Qwest and Staff ultimately entered into a proposed Price Cap Plan
3 settlement agreement ("Price Cap Plan"). Qwest asserts that in that case both Staff and Qwest
4 incorporated the same level of directory imputation of \$43 million. Contrarily, RUCO, a participant
5 in the 1999 proceeding, but not a party to the settlement in that case, states that in adopting the Price
6 Cap Plan, the Commission adopted an overall revenue requirement without specifically determining
7 any revenue items, including the imputation of directory operations.

8 Qwest believes that the Commission lacks jurisdiction over QCI's sale of Dex based on the
9 1996 Arizona Court of Appeals decision. Paragraph 3(b) of the 1988 Settlement Agreement
10 expressly provides that "the parties agree that the transfer of Yellow Pages assets from Mountain Bell
11 to USWD will be accepted by the parties as valid and the Commission will take no further action to
12 challenge that transfer." USWD is an unregulated affiliate, and in the 1996 case, the Court of
13 Appeals found, "[t]he Commission unequivocally agreed in 1988 to accept the transfer of directory
14 publication to an unregulated affiliate." 185 Ariz. At 281, 915 P.2d at 1236. Qwest argues that the
15 Court of Appeals was quite clear in stating that the Commission in the future could not challenge the
16 transfer of USWD either directly or indirectly. Qwest argues that A.R.S. § 40-285 does not apply to
17 a transfer of assets from an unregulated affiliate of a public service corporation.

18 Qwest also argued that the Commission's Affiliated Interest Rules to not apply to the Dex
19 transaction. Qwest claimed that the Commission's authority conferred by Article 15, Section 3 of the
20 Arizona Constitution is limited to the regulation of public service corporations, and pursuant to the
21 Arizona Supreme Court in Ariz. Corp. Com'n v. State ex rel. Woods, 171 Ariz. 286, 830 P.2d 807
22 (1992), the Commission's Affiliated Interest rules do not apply to the unregulated affiliate of Qwest
23 and an unaffiliated third party buyer. The Court in Woods upheld the validity of the Rules, but
24 Qwest argued the Court was careful to note that the Rules "apply only to public utilities subject to the
25 Commission's jurisdiction," and that the rules "only regulate transactions between those utilities and
26 their affiliates." Id. at 298, 830 P.2d at 819. Qwest argues the Commission cannot regulate
27 transactions that do not directly involve the regulated utility.

28 Prior to filing the Stipulation, Qwest argued that the Commission does not have jurisdiction

1 over the sale of Dex and that the 1988 Settlement Agreement would continue in effect following the
2 sale. Thus, the \$43 million imputation would continue in perpetuity. The present value of the current
3 \$43 million in perpetuity is \$529.9 million. See Qwest Post-hearing Exhibit filed June 3, 2003. Its
4 present value for 20 years is \$369 million. See Brosch testimony MLB-1.

5 Staff believes that the Commission has jurisdiction over the transfer of the Dex assets under
6 the Commission's Affiliated Interest Rules. Furthermore, Staff believes that the Commission may
7 have jurisdiction over the transfer pursuant to A.R.S. § 40-285 to the extent that Dex holds assets that
8 are used and useful in the provision of utility service. Staff asserted that Qwest's directory business
9 in Arizona has consistently been operated in coordination with the regulated telephone operations
10 under common ownership, so as to capture the tremendous economic benefits of publishing
11 directories in conjunction with (and as an offset to the costs of) providing telephone service. Staff
12 argued that in recognition of the linkage between the two businesses, the 1988 Settlement Agreement
13 provides for continued Commission oversight of the books and records of Dex and established a
14 presumptive imputation amount of \$43 million in revenues to be used in determining the intrastate
15 revenue requirement associated with any Company rate case in the future.

16 Staff further argued that the 1988 Settlement Agreement does not apply to an extraordinary
17 transaction as the instant sale to an unrelated third party buyer. Staff claims that the 1988 Settlement
18 Agreement pertained to and resolved a disputed specific transfer of certain assets among corporate
19 affiliates that occurred in 1984 and did not contemplate or address the pending sale of the publishing
20 business enterprise to an unaffiliated buyer.

21 Staff also argued that Qwest does not meet the conditions for limited waiver of the Affiliated
22 Interest Rules in this case. In Decision No. 58087, the Commission determined that Qwest, its parent
23 and affiliates are only required to file a notice of intent to organize or reorganize when organization
24 or reorganization is likely to 1) result in increased capital costs for Qwest; (2) result in additional
25 costs allocated to the Arizona jurisdiction; or (3) result in a reduction of Qwest's net operating
26 income. Staff argued Qwest has not demonstrated that the reorganization will not ultimately impact
27 capital costs to Qwest or ultimately result in a reduction of Qwest's net operating income.

28 In addition, Staff disputed Qwest's calculation of the gain from the sale that should be

1 allocated to ratepayers. Qwest attempted to carve out portions of directory revenue associated with
 2 certain Dex operations. By not including all Dex revenue, the value of the gain on the sale is
 3 reduced. Staff opposed the carve-out associated with Dex secondary directories and non-Qwest
 4 listings in primary directories. Qwest argued these operations are not part of the core directory
 5 business and should not be considered in determining imputation amounts. Secondary directories are
 6 discretionary additional phone books that Dex produces to maximize advertising revenues, and
 7 include regional and specialized directories such as “On The Go” intended to be used with cellular
 8 phones. Staff believes that secondary directory revenues should be considered in calculating the gain
 9 available for ratepayers. In Staff’s view, targeting markets is not innovative and would likely have
 10 been developed had Dex remained part of the phone company. Qwest also sought to exclude a
 11 portion of revenues associated with non-Qwest phone customer’s listings in its primary directories.
 12 Staff believes these too should be considered as part of the gain. Non-Qwest listings were included
 13 prior to 1984 and it is only good business practice to publish the most comprehensive directory
 14 possible.³

15 Prior to entering into the Stipulation, Staff was recommending that the Commission approve
 16 the sale subject to an increase in the imputation amount. Staff recommended a revenue credit of
 17 \$121.3 million per year for 20 years, or if price cap regulation is continued, a revenue credit of \$100
 18 million per year. The present value of Staff’s recommendation is \$1,040,000,000. See Brosch
 19 testimony MLB-1.

20 RUCO recommended that the Commission approve the sale but take steps to assure the
 21 revenue credit continue in the future. RUCO recommended adjusting the \$43 million imputation to
 22 reflect the increase value of fees and services Qwest should receive from the directory operations.
 23 RUCO adjusted the current imputation amount to reflect the growth in access lines and for inflation.
 24 RUCO calculated an imputation amount of \$89.9 million based on the growth in access lines, and
 25 further increased that amount to \$137.8 million after adjusting for inflation from 1984 to 2001.

26
 27 ³ Staff did not oppose Qwest’s carve out of revenues associated with LCI and New Ventures. LCI is an entity being
 28 bundled in the sale, and which leases telecommunications equipment to QCC. Its operations have nothing to do with
 directory publishing. New Ventures engages in non-traditional businesses such as internet directories, direct marketing
 services and other activities beyond directory publishing.

1 Johnson testimony at 51. The present value of \$137.8 million for 15 years is \$1,206,000,000. See
2 Grate surrebuttal at 31.

3 DOD calculated a pre-tax gain on the sale of Dex of \$1,217 million and advocated that
4 ratepayers are entitled to the full benefit of the gain, which is the full price of the Dex sale, less any
5 contributed assets that pass out of the Company, and less transaction costs. DOD recommended that
6 10 percent of the benefit be returned to ratepayers as an immediate bill credit. Under DOD's
7 proposal, the annual imputation would be \$58 million annually and the bill credit would total \$97
8 million.

9 The Proposed Settlement

10 The Stipulation between Staff and Qwest provides it supercedes the 1988 Settlement
11 Agreement related to directory imputation. Staff and Qwest agree that for a period of 15 years, the
12 amount of annual directory revenues imputed to Qwest and included in Qwest's test year operating
13 income will be \$72 million. The 15 year period begins on the date Qwest submits its first Price Cap
14 Plan review filing. At the end of the 15 year period, the imputation benefits cease. The present value
15 of the Stipulation (\$72 million for 15 years) is \$552.82 million.

16 Qwest and Staff agree that the Stipulation is in the public interest as it is a fair and reasonable
17 compromise of disputed positions concerning ratepayer interest in directory revenues; and it helps the
18 long-term viability of Qwest while providing for increased imputation benefits to ratepayers.

19 Staff asserts that the Stipulation is in the public interest because it resolves all of the
20 contentious jurisdictional issues and would obviate the need for continued litigation. Staff believes
21 the Stipulation reflects Staff's position that the 1988 Settlement must be replaced with a new
22 agreement which recognizes the extraordinary nature of the transaction now before the Commission.

23 Staff also argues that the Stipulation is in the public interest because it results in approval of a
24 transaction that Qwest claims is critical to Qwest's ability to avoid bankruptcy. QCI's current
25 liquidity problems are mitigated in the short term by using the Dex sale cash proceeds to satisfy
26 creditors. Even with increased liquidity from the Dex sale, Qwest may still face bankruptcy. Thus,
27 Staff believes that the sale of Dex gives the Commission an opportunity to benefit Arizona
28 ratepayers, while under a bankruptcy there may not be an opportunity to safeguard the customers'

1 interests.

2 Furthermore, Staff argues the Stipulation is in the public interest because it increases the
3 annual imputed directory revenues from \$43 million to \$72 million. In the event of a Qwest rate
4 case, earnings or Price Cap review, or other rate proceeding commenced between July 1, 2003 and
5 July 2018, the amount of annual directory revenues imputed to Qwest in determining its test year
6 operating income would be \$72 million, an annual increase of \$29 million. Staff's expert witness
7 testified that the revenue credit of \$43 million provided for in the 1988 Settlement Agreement has
8 been a persistently bad deal for ratepayers because it failed to provide for any growth in directory
9 publishing revenues or profits, effectively leaving all such growth for the sole benefit of stockholders.
10 Qwest argues that absent the Stipulation, based on past litigation, the imputation amount would likely
11 remain at \$43 million in a future rate proceeding.

12 Staff believes that a revenue credit provides a longer-term benefit for ratepayers than a one-
13 time bill credit. One of Staff's stated objectives in negotiating the Stipulation was to address the
14 deficiency of the 1988 Settlement for the long-term benefit of ratepayers by increasing the annual
15 revenue credits. Staff asserts that the Stipulation is a compromise that uses most of the Arizona
16 portion of the gain on sale to benefit customers, rather than shareholders as originally proposed by
17 Qwest. Staff believes a one-time bill credit would result in lower annual revenue credits which
18 would not have been as advantageous to ratepayers in the future.

19 Staff further argues that the Stipulation strikes an appropriate balance given the various
20 litigation risks presented. The 1988 Settlement Agreement has been controversial to administer in the
21 past due to ambiguities surrounding definitions and the measurement of "value of fees and services."
22 The new settlement provides for annual revenue imputation adjustments that are fixed in amount for
23 future rate cases and not subject to adjustment based upon future showings of "value" or other
24 subjective changes. In addition to settling the imputation issue, the proposed Settlement resolves
25 Qwest's jurisdictional arguments, what portion of the gain ratepayers should receive, and Qwest's
26 carve-out for secondary directories and non-Qwest listings.

27 Other States' Settlements

28 During the hearing there was much discussion and comparison of settlements that Qwest

1 reached in other states concerning the sale of Dex.

2 In Utah, where price cap regulation is mandated by statute, the commission and Qwest agreed
3 to one-time bill credits with no change in the underlying imputation of \$30.1 million per year. Under
4 Utah's price cap regulation, no rate case can occur in the future and ratepayers cannot realize any
5 Dex sale benefits in the form of increased annual imputation revenue credits. Staff states that the
6 one-time bill credit was negotiated as a compromise to attribute some benefits to ratepayers, albeit on
7 a one-time basis.

8 Staff states that the Washington settlement is based upon specific factual information and
9 regulatory practices in that state that differ from Arizona's treatment of directory revenues.
10 Washington has for many years practiced "full" imputation, as the Dex business remained a part of
11 the regulated telephone company. In each rate case in Washington, the commission evaluates the
12 achieved earnings of the publishing affiliate and returns all excessive directory earnings to ratepayers
13 through an imputation adjustment. This process has resulted in consistently growing imputation
14 amounts that exceeded \$85 million in the last Washington rate case (in 1997). The method for
15 imputing directory earnings has been affirmed by that state's supreme court in US WEST
16 Communications, Inc. v Util. and Transp. Comm., 949 P.2d17 (1997).

17 Staff states that contrary to the experience in Washington, in Arizona, imputation has been
18 limited by the 1988 Settlement Agreement that presumes an annual imputation of only \$43 million is
19 reasonable absent a showing that the value of fees and services to Qwest is greater. The earnings-
20 based imputation approach (as used in Washington) was recommended by Staff witness Brosch and
21 ordered by the Commission in a 1993 rate case, but was later overturned by the Court of Appeals as
22 inconsistent with the 1988 Settlement Agreement.

23 Staff argues that because of the unique history of litigation in Arizona, the 1988 Settlement
24 Agreement and the Price Cap Plan Review, the Arizona Stipulation compares favorably to both Utah
25 and Washington. Staff notes that while the nominal values in the Arizona Stipulation are lower than
26 in Washington, when one compares the incremental value to Arizona ratepayers relative to the 1988
27 Settlement Agreement, to the incremental benefits in either Washington or Utah, the Arizona
28 Stipulation adds greater ratepayer value.

Opposition to Settlement

RUCO and DOD oppose the proposed Settlement.

The DOD does not believe the proposed Settlement is in the public interest because it does not provide adequate compensation to local ratepayers. Mr. Lee, the witness for the DOD, testified that the proposed settlement does not provide an appropriate balancing of litigation risk versus settlement benefits, and expressed concern that ratepayers may never actually see a benefit from the sale of Dex without a bill credit. Based on the parties pre-settlement positions, DOD believes that a compromise with a value of \$866 million, the mid-point between Staff's original proposal (\$1,040 million) and the gain on the sale Qwest allocates to Arizona, is reasonable. DOD believes that 10 percent, or \$86 million, should be returned as an immediate bill credit.⁴

Mr. Lee, on behalf of the DOD believes that ratepayers are entitled to 100 percent of the gain from the sale. He testified that with the divestiture in 1984, AT&T's directory publishing business was assigned to the BOCs in order to generate "a substantial subsidy for local telephone rates." Lee Rebuttal at 5, citing United States v. American Tel. and Tel. Co. et al., 553 F. Supp 131 at 224 (1982). In addition to including the gain associated with the secondary directories and non-Qwest listings, as well as LCI and New Ventures (which Qwest excludes), DOD believes the benefits for ratepayers should reflect the pre-tax gain associated with the sale. DOD claims that, in effect, Qwest will not pay taxes on the gain from the sale because the net-operating losses from its non-regulated activities will exceed the one-time gain from the sale of Dex. DOD argues that any portion of the gain from the sale of Dex that does not benefit ratepayers will represent a subsidy of QCI's non-regulated operations. DOD believes that shareholders receive valuable compensation for the sale because the cash flow will aid QCI in meeting its cash requirements resulting from the losses in the non-regulated arena.

Mr. Lee argues the proposed Arizona Settlement, with a value of \$556 million, is even lower than the benefit of Qwest's calculation of the gain (\$685 million), and thus, did not represent a reasonable compromise. DOD Brief at 10. Mr. Lee proposed that a reasonable compromise would

⁴ Based on the number of access lines used in RUCO's calculations, the bill credit would be approximately \$29.74 per line.

1 have been a value of \$862 million, determined by splitting the difference between the positions of
2 Staff and Qwest.

3 Staff notes that Mr. Lee allocated the entire gain as a subsidy to ratepayers even though there
4 were several litigation risks that Staff believes should have been considered. Staff argues that any
5 bill credit would have to be offset from any imputation amount agreed to, and thus dilute the more
6 permanent benefits achieved in the Stipulation. Staff believes that a higher imputation amount for a
7 period of 15 years would be of overall greater benefit to Arizona consumers now and in future years.

8 Staff argues the DOD proposals have an extreme impact on Qwest at a time when Qwest is
9 attempting to improve its liquidity and access to capital markets. Staff notes that the DOD's
10 proposed front-loaded customer credits does not balance the interests of ratepayers and shareholders
11 and may undermine the Company's ability to remain solvent.

12 Qwest claims that Mr. Lee does not provide sufficient support for his position that ratepayers
13 are entitled to 100 percent of the gain on the sale. Mr. Lee cites the Modified Final Judgment in
14 which he argues Judge Green "gave" the directory operations to ratepayers to serve as a source of
15 subsidy for basic local rates. Qwest argues that 1) the Modified Final Judgment has been vacated; 2)
16 the Modified Judgment made no indication of an attempt to create a perpetual subsidy and 3) the
17 subsidy was not the primary basis for the decision to keep the directory operations with the BOCs.

18 In Arizona, Qwest claims, precedent does not support assigning 100 percent of the gain from
19 a sale of assets to the ratepayer even when those assets are clearly utility assets. Qwest Brief at 25.
20 Qwest states that under the holding of Democratic Central Committee of the Dist. of Columbia v
21 Washington Metro. Area Transit Comm'n, 158 U. S. App. D.C. 7, 458 F.2d 786, 806 (D.C. Cir.
22 1973), *cert denied*, 415 U.S. 935 (1973), the gain from the sale of utility assets belongs to the party
23 that bore the risk of capital loss with regard to the asset question, or who bore the burden of the utility
24 activity in question. Qwest argues that ratepayers have not borne a risk of capital cost or the burden
25 of the cost recovery on directory operations.

26 RUCO believes that the Settlement is not in the public interest because the agreed upon
27 imputation amount of \$72 million is inadequate and it results in a severe mismatch between the
28 duration of imputation credits (15 years) and the duration of the service that will be provided by

1 Qwest under the new Publishing Agreement (up to 50 years). RUCO recommends that the
2 Commission, at a minimum, modify the Stipulation to provide directory imputation of \$72 million for
3 a minimum of forty years. RUCO's witness, Dr. Johnson, did not recommend that Arizona require
4 Qwest to provide a portion of the gain to ratepayers in the form of a bill credit because to do so
5 would undermine Qwest's need for cash flow which is the entire reason for selling the Dex assets.

6 RUCO argues that the Stipulation does not provide as good a deal for Arizona ratepayers as
7 that Qwest agreed to in the state of Washington. RUCO states that Qwest's presence in Washington
8 is comparable to Arizona based on the number of access lines and publishing revenues, but that
9 Qwest agreed to a much higher level of imputation in Washington, providing a much better deal for
10 Washington consumers than Arizona consumers would get under the Stipulation. RUCO Brief at 4.
11 In addition, Washington consumers receive an approximate \$29 bill credit, while the Arizona
12 Stipulation does not include any bill credits.

13 RUCO does not agree with Staff that the difference in the legal and regulatory environments
14 between Arizona and Washington justifies a \$38 million difference between the proposed
15 imputations for the two states. RUCO argues that the 1988 Settlement Agreement does not limit the
16 amount of the imputation to \$43 million. The Court of Appeals Decision that rejected the
17 Commission's attempt to increase the imputation amount from Dex revenues to \$60 million, did so
18 because the Commission relied on a methodology contrary to that agreed to in the 1988 Settlement
19 Agreement. Staff had recommended an imputation of \$60 million by attributing to US West all of
20 USWD's profits that exceeded the 11.4 percent rate of return that would have been permitted had
21 USWD remained a regulated entity. RUCO argues that the Court noted that the Commission can
22 adjust the presumptive \$43 million imputation either upward or downward as long as the
23 Commission makes the adjustment based on evidence of fees and the value of services. US West v
24 ACC, 185 Ariz. 277, at 281, 915 P.2d 1232, 1236 (App. 1996). Thus, RUCO argues that based on
25 the Court of Appeals decision, the Commission can adjust the presumptive imputation value upward
26 (or downward) so long as the basis for the adjustment is fees and the value of services received by
27 Qwest from the buyer. RUCO Brief at 7.

28 Staff and Qwest believe the 15 year period is appropriate because any longer period starts to

1 introduce significant uncertainty and diminished tangible value to customers. Mr. Lee, on behalf of the
2 the DOD also testified that the 15 year period was reasonable because it is difficult to predict what
3 form of regulation will exist beyond the next 15 years. Assuming any increase in competition or
4 continuation of price cap regulation, Staff argues that revenue credits beyond 15 years would create
5 no value to customers because traditional regulation is unlikely to exist so far in the future. At the
6 same time, Staff argues, extending the term would unreasonably reduce the amounts available in
7 early years in order to produce more distant and highly uncertain benefits.

8 Qwest and Staff argue that RUCO's suggestion that the imputation amount should be
9 increased based on access line growth and inflation fails as a matter of law because the 1988
10 Settlement Agreement does not provide for changes in imputation based on access line growth or
11 inflation. Staff notes that the Commission has never employed such an approach. Most importantly,
12 Staff claims that RUCO has made no showing that changes in access lines or changes in inflation
13 have anything to do with directory advertising revenues or profits in Arizona.

14 Qwest argues that none of the parties opposing the Stipulation offered any persuasive
15 evidence or analysis to support the proposition that 100 percent of the gain should be given to
16 ratepayers or considered the litigation risk that ratepayers are entitled to something less than 100
17 percent. Furthermore, in evaluating the settlements in the three states, Qwest states that it is
18 important to recognize that each state's portion of the Dex sale differs. Qwest allocated the gain
19 among the states based on revenues within the states from directory advertising derived from Qwest
20 customer listings in Qwest primary directories. On that basis, Washington produces the most
21 revenues of the three states and Utah the least.

22 The Buyer

23 Dex Holdings asserts that there has been no dispute in this docket that Dex Holdings is a well-
24 qualified buyer or that Dex Holdings will operate Dex in a manner that will continue to benefit
25 Arizona. Dex Holdings argues that the Commission should approve the sale subject to the terms of
26 the Stipulation as it was reached after extensive negotiation and thorough analysis of the litigation
27 risks and the public benefits of allowing the sale to proceed.

28 Dex Holdings asserts the record is undisputed that its owners have extensive financial

1 resources and industry experience that will allow them to operate Dex successfully. Dex Holdings
2 has demonstrated an ability to raise capital, having funded and closed the Dexter portion of the
3 transaction which required \$2.75 billion in debt and equity capital. Dex Holdings' members, Carlye
4 and WCAS, possess investment professionals with a deep understanding of telecommunications.
5 William Kennard, former chairman of the FCC, serves as Managing Director of the
6 Telecommunications and Media Group at Carlye. James Attwood, a current Carlye partner and
7 former Verizon Executive Vice President for Strategy, is the Co-Chairman of the Board of Dex
8 Holdings.

9 There will be a continuity of Dex management and operations as Dex Holdings intends to
10 retain the existing Dex management and employees. Dex Holdings intends to refine and improve the
11 Dex directories and to pursue expansion in related areas, such as Internet directory publishing.

12 Dex Holdings is contractually bound to provide services necessary to enable Qwest to satisfy
13 its directory publishing obligations. In addition, Dex Holdings has expressed an intent to work with
14 the Commission to meet Commission concerns regarding directories in Arizona. Dex Holdings is
15 contractually obligated to implement Qwest's legal and regulatory obligations concerning directories,
16 even if those obligations change over time.

17 Dex Holdings argues that the proposed sale is in the public interest because 1) it is an
18 opportune time for the sale; 2) the settlement is a fair balance between Qwest and Arizona customers
19 in the distribution of the gain; 3) there are substantial benefits flowing from the fact that the new
20 owner is not affiliated with an incumbent LEC; and 4) local exchange competition can benefit from
21 the sale of Dex.

22 Dex Holdings asserts that directory competition from internet search engines or directory
23 services may devalue Dex unless the owner has sufficient resources and ability to respond to
24 competitive pressures. Given Qwest's precarious financial condition, Dex Holdings questions
25 Qwest's ability to provide the necessary funding. Dex Holdings argues that no party has seriously
26 challenged the overall sales price for Dex. It notes that the sale attracted a number of qualified
27 buyers and that the auction process whittled the number of potential buyers to two and resulted in
28 protracted negotiations over final sales terms.

1 Dex Holdings states that the proposed Settlement increases the imputation amount from \$43
2 million to \$72 million, which exceeds the rate of inflation since 1984. The Settlement is also
3 structured to give Arizona consumers the immediate benefits from that increased imputation in the
4 upcoming review of the Qwest Price Cap Plan. Dex Holdings encourages the Commission to keep in
5 mind that the principal reason for the sale – to improve Qwest’s financial condition to avoid
6 bankruptcy – benefits Arizona consumers by allowing the Commission to retain full control over the
7 disposition of Qwest assets which might not be the case if the bankruptcy court takes control.

8 As an independent entity, Dex Holdings asserts, Dex will have the ability to use the profits
9 from its directory publishing business to research and develop new and improved products,
10 maximizing the value of those assets, and providing new services to consumers and advertisers. Dex
11 Holdings will not be burdened with the financial difficulties of its parent company.

12 Finally, Dex will no longer be controlled by the ILEC and will have more incentive to work
13 with CLECs to create innovative products or opportunities to allow CLECs to compete more
14 effectively.

15 Evaluation of the Stipulation

16 No party in this docket recommends denying approval of the sale of Dex to Dex Holdings.
17 No party argued that the bankruptcy that could result if the sale is denied would benefit Arizona
18 ratepayers. The evidence supports approving the sale. Parties opposing the Stipulation between Staff
19 and Qwest argue that various aspects of the agreement should be modified in order to provide greater
20 benefits to consumers.

21 Many issues were raised in the course of this proceeding. Qwest argued that the Commission
22 does not have jurisdiction at all over the sale, or that at best the Commission’s jurisdiction is limited
23 by the 1988 Settlement Agreement. Further, Qwest raised arguments that ratepayers are not entitled
24 to share in any gain attributable to secondary directories (regional and specialized directories) and
25 directory revenue associated with non-Qwest listings as well as Dex’s internet directory revenues and
26 revenues associated with LCI which owns a limited partnership interest in a business that leases
27 telecommunications equipment to QCC, the long distance affiliate of QCI.

28 The litigation risks present in this case include: 1) an appellate determination that the

1 Commission does not have jurisdiction; 2) a determination that the Commission's authority is limited
2 by the 1988 Settlement Agreement; and 3) meaningful disputes concerning the method of calculating
3 and allocating the gain. If a court determines that that the Commission lacked jurisdiction over the
4 sale of Dex, ratepayers might receive no benefit other than what they already receive under the 1988
5 Settlement Agreement. Even if a court determined that the Commission did have jurisdiction it could
6 agree with Qwest's position that ratepayers are not entitled to the portion of gain that can be
7 attributable to lines of business that were developed after 1984. The litigation risk is not
8 insubstantial.

9 We find that after considering all of the evidence in this case that the Stipulation between
10 Staff and Qwest is a fair and reasonable compromise. It provides ratepayers with the benefit of a \$29
11 million increase in the annual imputation, which will flow to ratepayers when the Commission
12 considers Qwest's Price Cap Plan filed in July 2003 and expected to be in effect in early 2004. The
13 value of the gain being returned to ratepayers under the Stipulation is a little over half the value of the
14 total gain as calculated by Staff's witness. We believe this sharing of the gain is an appropriate and
15 fair allocation.

16 We are not persuaded by the arguments against the Stipulation. An immediate bill credit
17 would result in a lower imputations over the term of the agreement and would diminish the cash flow
18 available to Qwest needed to return it to financial health. Thus, we do not believe a bill credit is in
19 the public interest. We further believe that the 15 year term is reasonable in light of the changes in
20 the regulatory paradigm.

21 In comparing the settlements reached in Utah and Washington with that proposed here, we
22 must consider the benefits being received by ratepayers prior to the sale of Dex as well as the
23 different legal precedents and forms of regulation in the various states. In Washington, directory
24 assets have remained with the regulated utility and have been periodically adjusted. The experience
25 in Arizona has been very different. Staff and the Commission have attempted to increase the amount
26 of the imputation in the past, but have been limited by the terms of the 1988 Settlement Agreement
27 and case law interpreting that decision. The reasonableness of the proposed settlement in Arizona
28 has to be evaluated by considering the unique circumstances in Arizona and the risks that ratepayers

1 could receive significantly less if the issues are litigated.

2 * * * * *

3 Having considered the entire record herein and being fully advised in the premises, the
4 Commission finds, concludes, and orders that:

5 **FINDINGS OF FACT**

6 1. On September 3, 2002, QCI, QSC and Qwest filed with the Commission a request for
7 Waiver or Application for Approval of the Sale of the Arizona Operations of Dex. The Companies
8 seek approval to sell the Dex directory publishing assets to Dex Holdings, an unrelated third party
9 buyer. In its Notice and Application, Qwest requested that the Commission declare that: (1) the
10 transaction falls within the scope of the waiver granted in Commission Decision No. 58087 or (2) the
11 sale of Directory Assets is not subject to Commission regulation based on a 1988 Mountain Bell
12 Settlement Agreement. Alternatively, Qwest requested that the Commission waive compliance in
13 part with the Affiliated Interest Rules or approve the Sale of Directory Assets.

14 2. In letters dated September 16, 2002 and October 25, 2002, Qwest waived and/or
15 extended the deadlines set forth in A.A.C. R14-2-806(C) and R14-2-803(B).

16 3. Staff filed a request for a procedural order on December 4, 2002.

17 4. On December 24, 2002, the Commission issued a Procedural Schedule that established
18 a schedule for filing testimony and set the matter for hearing on May 6, 2003.

19 5. The Commission granted intervention to RUCO on October 18, 2002; to WCom on
20 December 4, 2002; to the DOD on February 4, 2003 and to Dex Holdings on January 10, 2003.

21 6. On January 28, 2003, Qwest filed the testimony of its witnesses Maureen Arnold,
22 George Burnett, Peter Cummings and Brian Johnson, and Dex Holdings filed the testimony of
23 William Kennard.

24 7. On March 4, 2003, DOD filed the rebuttal testimony of Richard Lee.

25 8. RUCO filed rebuttal testimony of Dr. Ben Johnson on March 19, 2003.

26 9. After being granted an extension by Procedural Order dated March 23, 2003, Staff
27 filed the rebuttal testimony of Michael Brosch on March 28, 2003.

28 10. On March 28, 2003, Staff filed notice that it had reached a settlement in principal with

1 Qwest.

2 11. On April 18, 2003, Staff and Qwest filed a Joint Notice of Filing Settlement
3 Agreement and Motion for Procedural Order.

4 12. Pursuant to the March 23, 2003 Procedural Order, Qwest filed the surrebuttal
5 testimony of Maureen Arnold, Philip Grate, Peter C. Cummings and Anne Koehler-Christensen on
6 April 18, 2003.

7 13. In light of the Stipulation between Staff and Qwest, the Commission issued a
8 Procedural Order on April 25, 2003 setting a new schedule.

9 14. On April 28, 2003, Qwest filed the testimony of Maureen Arnold and Staff filed the
10 testimony of Michael L. Brosch in support of the Settlement Agreement. On the same date, Dex
11 Holdings filed a statement in support of the Settlement Agreement.

12 15. On May 9, 2003, the DOD filed rejoinder testimony of Richard Lee and RUCO filed
13 the rejoinder testimony of Dr. Ben Johnson, both opposing the Settlement.

14 16. A hearing convened on May 16, 27, and 28, 2003, to consider the Stipulation.

15 17. QCI and Qwest have experienced steadily worsening financial situations and their debt
16 loads have impacted their ability to obtain financing. Selling Dex is a critical component in QCI's
17 overall debt restructuring and de-leveraging. The proceeds of the second phase of the Dex sale
18 remain critical to further reduce debt and return the Companies to financial health. If the sale is not
19 consummated there is a substantial risk that Companies face bankruptcy.

20 18. The Stipulation between Staff and Qwest provides it supercedes the 1988 Settlement
21 Agreement related to directory imputation. The Stipulation provides that for a period of 15 years, the
22 amount of annual directory revenues imputed to Qwest and included in Qwest's test year operating
23 income will be \$72 million. The 15-year period begins on the date Qwest submits its first Price Cap
24 Plan review filing. At the end of the 15-year period, the imputation benefits cease.

25 19. The 1988 Settlement Agreement provided that (1) the transfer of directory publishing
26 assets from Mountain Bell to USWD was valid; and 2) the Commission would "take no further action
27 to challenge that transfer." Further, the 1988 Settlement Agreement provides that in future rate cases
28 filed by Mountain Bell, the Commission, in arriving at the test year operating income, will consider

1 the fees and the value of services received by Mountain Bell from USWD.

2 20. In US WEST Communications Inc. v. Arizona Corp. Com'n, 185 Ariz. 277, 915 P.2d
3 1232 (App. 1996), the Court of Appeals held that the Commission's attempt to increase the amount
4 of directory revenue imputation to \$60 million directory imputation violated the 1988 Settlement
5 Agreement because the Commission did not use the methodology approved in the 1988 Settlement
6 Agreement, which depended upon proof of the fees and the value of service received.

7 21. The litigation risks present in this case include: 1) an appellate determination that the
8 Commission does not have jurisdiction; 2) a determination that the Commission's authority is limited
9 by the 1988 Settlement Agreement; and 3) meaningful disputes concerning the method of calculating
10 and allocating the gain.

11 22. The Stipulation provides a reasonable compromise of the issues presented in this case.
12 It provides ratepayers with a \$29 million increased annual revenue credit and provides that such
13 benefit will be considered with Qwest's Price Cap Plan review expected to become effective in 2004.
14 The allocation of the gain between ratepayers and shareholders is fair and reasonable.

15 23. Dex Holdings, the Buyer, has management experience in the telecommunications
16 industry and has access to the financial resources necessary to acquire and operate Dex. Dex
17 Holdings has committed on the record to work with the Commission to meet Commission concerns
18 concerning directory publishing in Arizona.

19 20 **CONCLUSIONS OF LAW**

21 1. Qwest is a public service corporation within the meaning of Article XV of the Arizona
22 Constitution and under Arizona Revised Statutes, Title 40, and the Affiliated Interest Rules A.A.C.
23 R14-2-801-806.

24 2. The Commission has jurisdiction over Qwest and of the subject matter of the
25 Application.

26 3. Notice of the proceeding was given in accordance with the law.

27 4. Dex Holdings is a fit and proper entity to acquire and operate Dex.

28 5. The Stipulation is a fair and reasonable resolution of the issues raised in this docket

1 and is in the public interest.

2 **ORDER**

3 IT IS THEREFORE ORDERED that the Stipulation between Qwest and Commission Staff
4 attached hereto as Exhibit A is approved.

5 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

7
8
9 CHAIRMAN COMMISSIONER COMMISSIONER

10
11 COMMISSIONER COMMISSIONER

12
13 IN WITNESS WHEREOF, I, JAMES G. JAYNE, Interim
14 Executive Secretary of the Arizona Corporation Commission,
15 have hereunto set my hand and caused the official seal of the
16 Commission to be affixed at the Capitol, in the City of Phoenix,
17 this ____ day of _____, 2003.

18 JAMES G. JAYNE
19 INTERIM EXECUTIVE SECRETARY

20 DISSENT _____

21 DISSENT _____

22 JR:

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